



Federal Accounting Standards Advisory Board

February 13, 2004

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: Elements of the Financial Statements:
The Essential Characteristics of Federal Government Assets

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Introduction

At the December 2003 meeting, the Board discussed the general approach to defining elements of the financial statements. The Board decided that the definition of each element should be based on the essential or fundamental characteristics of each element. Therefore, the Board should achieve agreement on those characteristics before discussing the precise wording of the definitions. The goal for the March meeting is to reach agreement on the essential characteristics of federal government assets.

In December, the Board members discussed whether the three essential characteristics of assets identified by the FASB in its Concepts Statement No. 6, *Elements of Financial Statements* (1985), are applicable to federal government assets. The Board requested additional consideration of whether some concept of “ownership” by the entity is an essential characteristic and also what is meant by “control” of the economic benefits or service potential embodied in a federal government asset. This memo discusses those concepts. As a point of departure, reference is again made to the FASB’s views on these issues. The views of other standard-setting authorities are included for comparison.

OWNERSHIP AND CONTROL

Is Ownership by the Reporting Entity an Essential Characteristic of its Assets? What is Meant by Control in This Context?

According to the FASB,¹ the three essential characteristics of an asset are:

- a) It embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows,
- b) A particular entity can obtain the benefit and control others' access to it, and
- c) The transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

The FASB's definition is based on those three characteristics and is:

Assets are probable future economic benefits *obtained* or *controlled* by a particular entity as a result of past transactions or events. (Para. 25, *emphasis added*)

The definition does not refer to ownership; the FASB indicates that it considers legally enforceable ownership rights to be a *common* characteristic of assets but not an *essential* one. In the FASB's view,

... although the ability of an entity to obtain benefit from an asset and to control others' access to it generally rests on a foundation of legal rights, legal enforceability of a claim to the benefit is not a prerequisite for a benefit to qualify as an asset if the entity has the ability to obtain and control the benefit in other ways. (Para. 26)

An example of "other ways" is given in paragraph 187: "... [E]xclusive access to future economic benefits may be maintained by keeping secret a formula or process."

Thus, the phrase "can obtain the benefit" in essential characteristic b) (see above), may be viewed as an equivalent notion to ownership, in the sense of access to and right to use an asset, but without an assumption that the right to access and use is legally enforceable.

The FASB explains its concept of control, as an essential characteristic of an asset, as follows :

¹ FASB Concepts Statement No. 6, para. 26.

. . . To have an asset, an entity must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to that benefit by others, for example, by permitting access only at a price. (Para. 183)

and further:

. . . [A]n asset of an entity is the future economic benefit that the entity can control and thus can, within limits set by the nature of the benefit or the entity's right to it, use as it pleases. The entity having an asset is the one that can exchange it, use it to produce goods or services, exact a price for others' use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners. (Para. 184)

Thus, the concept of "control," as the FASB describes it, also may be viewed as equivalent to ownership. The question, therefore, is how this concept of control and regulation of others' access to the benefits embodied in an asset differs from legal ownership and why the FASB thought it necessary to make the distinction.

The key appears to be the FASB's view that an asset should not be regarded as a single physical thing that provides economic benefits, but rather as a "bundle of benefits" that may be beneficial to more than one entity, even though the physical item (e.g., a building) can only belong to one entity. FASB explains this concept as follows:

The definition of assets focuses primarily on the future economic benefit to which an entity has access and only secondarily on the physical things and other agents that provide future economic benefits. ***Many physical things and other agents are in effect bundles of future economic benefits that can be unbundled in various ways, and two or more entities may have different future economic benefits from the same agent at the same time or the same continuing future economic benefit at different times.*** For example, two or more entities may have undivided interests in a parcel of land. Each has a right to future economic benefit that may qualify as an asset under the definition in paragraph 25, even though the right of each is subject at least to some extent to the rights of the other(s). Or, one entity may have the right to the interest from an investment, while another has the right to the principal. Leases are common examples of agreements that unbundle the future economic benefits of a single property to give a lessee a right to possess and use the property and give a lessor a right to receive rents and a right to the residual value. Moreover, a mortgagee may also have a right to receive periodic payments that is secured by the leased property. (Para. 185, ***emphasis*** added)

Thus the FASB's use of the word "obtain" rather than "own" in its identification of the essential characteristics of an asset and the related definition is consistent with its conceptual conclusion about the nature of an asset. It also may serve as a practical precaution against readers assuming that certain rights are not assets—a capital lease agreement on a building, for example—because the lessee does not have legally enforceable ownership of the building during the term of the lease, whereas the lessee in substance obtains benefits from the lease and can control or regulate other entities' access to those benefits.

Other Standard Setters' Views

Other standard-setting authorities appear to have adopted similar views to those of the FASB with regard to the concepts of ownership and control, although the wording of their definitions and of the essential characteristics underlying them is not identical.

Governmental Accounting Standards Board (GASB)

The GASB's unpublished working paper on elements of the financial statements² contains the following definition of assets and their essential characteristics:

Assets are a governmental unit's rights to goods, services, or cash flows as a result of past transactions or other events.

The three essential characteristics that all assets have are:

- (a) The existence of service potential or future economic benefits,
- (b) The service potential or future economic benefits must be controlled by the governmental unit, and
- (c) The service potential or future economic benefits must arise from past transactions or other events . . . (page 4)

Essential characteristic (b) focuses on control, similar to the FASB's characteristic b), but does not mention a concept of obtaining benefits. The GASB's definition itself, however, does not mention control, although the concept may be implicit. A previous definition did refer to control and was closer to the FASB's wording:

Assets are rights to service potential (economic benefits) controlled by an entity as a result of past transactions or other events.

The working paper does not discuss concepts of ownership or control. The GASB intends to resume its project on defining elements later this year. It is not known, therefore, at this point whether the above tentative definitions will change and, if so, in what way.

Australian Accounting Research Foundation (AARF) and Accounting Standards Board (ASB)

In their Statement of Accounting Concepts 4 (SAC 4),³ the AARF and ASB identify control as an essential characteristic of assets and include control in the asset definition. Unlike FASB Concepts Statement 6, the Australian SAC 4 was developed with the financial statements of governments in mind, as well as those of corporations and private

² GASB, "Working Definitions of Financial Statement Elements and Related Concepts," 1998.

³ AARF and AASB, Statement of Accounting Concepts 4, *Definition and Recognition of the Elements of Financial Statements*, 1995.

not-for-profit organizations. Many of the conclusions, however, are very similar to those of the FASB.

Essential Characteristics of Assets

. . . First, there must be future economic benefits. Second, ***the entity must have control over the future economic benefits such that it is able to enjoy the benefits and deny or regulate the access of others to the benefits.*** Third, the transaction or other event giving rise to the entity's control over the future economic benefits must have occurred. (Para. 15, ***emphasis added***)

No specific reference is made to “owning” or even “obtaining” economic benefits, although obtaining them may be assumed from the notions of control and ability to enjoy the benefits. Control is specifically defined in the same paragraph as the definition of assets. These definitions are:

“Assets” are future economic benefits controlled by the entity as a result of past transactions or other past events; and

“control of an asset” means the capacity of the entity to benefit from the asset in the pursuit of the entity's objectives and to deny or regulate the access of others to that benefit. (Para. 14)

Similar to the FASB, the AARF and AASB indicate that legal enforceability is a common but not an essential characteristic of an asset. Also similar to the FASB, control of economic benefits is considered an essential characteristic of an asset, regardless of ownership. The issue is discussed as follows:

Legal enforceability

Control over future economic benefits has been identified as an essential asset characteristic. While the ability of an entity to exercise control will often stem from the existence of legally enforceable rights, the absence of legal ownership does not preclude the existence of control. For example, an entity may protect the future economic benefits embodied in a formula or an invention not by obtaining a patent but by maintaining secrecy. ***Similarly, the presence of legal rights does not guarantee control.*** For example, goods may be sold subject to reservation of title, whereby a stipulation is placed in a sale of goods agreement to the effect that ownership of the goods does not pass to the buyer until the time of payment. The substance of these arrangements is that the buyer effectively has control over the future economic benefits embodied in the delivered goods unless there is an incapacity to pay. The seller, while possessing legal title and therefore the right to resume possession in the event of the buyer's default, does not control the future economic benefits embodied in the goods. ***Another example is where a government entity, such as a government department, does not have legal ownership of the buildings in which it operates, such ownership vesting in another government entity, but controls the future economic benefits embodied in the buildings because of the terms of a particular government***

policy, ministerial directive or administrative arrangement. (Para. 37, *emphasis added*)

United Kingdom Accounting Standards Board (UK ASB)

In Chapters 2 and 4 of its Statement of Principles,⁴ the UK ASB presents views of legal ownership and control of assets that are generally similar to those expressed by the FASB and the Australian boards. However, unlike the FASB's definition, the UK definition does not include a concept of "obtaining" benefits as an essential characteristic:

Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. (Para. 4.6)

Control by the reporting entity is considered an essential characteristic of an asset; however, control need not be legally enforceable. Thus,

. . . [R]ights or other access . . . often . . . are obtained by legal ownership of the underlying item of property. . . . However, legal rights to future economic benefits derived from an item of property can be obtained without having legal ownership of the property itself, as is the case, for example, where property is leased. (Para. 4.8 through 4.10)

Also:

Other legal rights that give rise to assets include the right to require other parties to make payments or render services and the right to use a patent or trade mark. (Para. 4.11)

Access to future economic benefits—and therefore an asset—can also exist in the absence of legal rights. An example might be an unpatented invention. (Para. 4.12)

And:

. . . An entity will control the rights or other access if it has the ability both to obtain for itself any economic benefits that will arise and to prevent or limit the access of others to those benefits. (Para. 4.17)

This control does not need to be legally enforceable, which means that weight can be given to economic and social sanctions when these are effective in inducing entities to fulfil promises or to comply with widely accepted business practices or customs. (Para. 4.18)

As suggested earlier, in relation to the FASB's views, the conclusion that legal ownership is not an essential characteristic of an asset appears to derive from the view of an asset as a "bundle of benefits," rather than a single item of property. The UK ASB expresses a similar view. Thus,

⁴ Accounting Standards Board (United Kingdom), *Statement of Principles for Financial Reporting*, 1999.

The requirement that the rights or other access should be controlled by the entity treating them as its asset means that a particular right or other access to future economic benefits will appear in only one set of single entity financial statements, because such rights or access can be directly controlled by only one entity. . . . (Para. 4.19)

On the other hand, a single item of property may give rise to assets of more than one entity. If two entities control the rights to different future economic benefits from the same item of property, both entities will have an asset (subject to the other aspects of the definition being met). However, although the item of property underlying the asset will be the same, the assets will be different because the future economic benefits are different. For example, if an entity leases an item of property to another entity, both entities will recognize an asset based on rights relating to the leased item of property although, as the lessor's rights will not be identical to the lessee's, the assets will not be the same. (Para. 4.20)

Canada and New Zealand

The Canadian and New Zealand standard setters' definitions of assets focus on control and do not mention a concept of legal ownership in the definitions.⁵

Canada:

Assets are economic resources controlled by an entity as a result of past transactions or events from which future economic benefits may be obtained.

New Zealand:

Assets are economic resources controlled by an entity as a result of past transactions or events from which future economic benefits may be obtained.

Sweden

As a final example, a Swedish concepts statement⁶ may be of particular interest to the FASAB because, unlike the others cited, it was developed specifically for the central government. Similar to the other authorities' definitions, the notion of control is significant in the Swedish definition of assets:

. . . An asset is a resource that is controlled by an entity as a result of past events and which is expected to give the entity economic benefits or service potential in the future.

An asset is controlled by an agency if it is administered by the agency on behalf of central government and the asset or its yield can be used until further notice by the agency in accordance with the objectives of operations. (Para. 54)

⁵ Sources: Canadian Institute of Chartered Accountants. CICA Handbook. New Zealand Accounting Research Standards Board. Exposure Draft 60, 1991. The views expressed in these documents are generally similar to those of the FASB, with regard to the essential characteristics of assets.

⁶ Public Governance and Territorial Development Directorate, Public Management Committee, *Conceptual Framework for the Preparation of Financial Statements in the Central Government of Sweden*, 2003.

Also similar to the other authorities' views, the Swedish authors do not view legal ownership as an essential characteristic of an asset. Thus,

Many assets, for example claims and properties, are associated with legal rights, for example the right of ownership. The right of ownership devolves formally on central government. This right can, with certain limitations, be considered to be delegated to individual agencies that administer the asset on behalf of the central government. ***However, when determining the existence of an asset, the right of ownership is not of decisive importance.*** Accordingly, for example leased property constitutes an asset if the entity has control over the economic benefits or service potential associated with the asset. ***Despite the fact the possibilities available to the entity to make use of the value of an asset are usually a consequence of legal rights, the definition of an asset can be met without any rights of this type in existence.*** (Para. 59, *emphasis added*)

Control and Fiduciary Activities

The emphasis placed by the definitions of various authorities on *control* of the benefits or service potential embodied in an asset, rather than on ownership of the asset as an item of property, raises a question about fiduciary activities. If an entity controls resources on behalf of another entity—for example, through a trust or other fiduciary agreement—does that mean that the first entity has an asset?

The previous excerpts from various discussions of control support answering “no” to this question. Although none of the sources discussed in this paper directly addresses this issue, they generally discuss control in terms of the reporting entity’s ability to obtain the benefits embodied in the asset *for itself*—that is, for its own programs and operations—with the consequent right to use, convert, exchange, sell, or otherwise dispose of the asset as it sees fit (albeit with due compliance with restrictions placed by donors or other resource providers on use of the item). Thus, holding or managing resources *for the exclusive benefit of another entity, rather than for the benefit of the holder/manager’s own programs* does not give the holder/manager control in the sense that term is used by the FASB and others—the ability to access the benefits embodied in the asset and deny or regulate others’ access to those benefits.

The manager/holder cannot deny access by the beneficiary entity because the benefits inure to that entity. Moreover, the entity on whose behalf the resources are being held often can control access to the resources, in the sense that it can determine (albeit with some restrictions) when to withdraw resources and it may assign rights to those resources to others. Therefore, it seems clear that in a true fiduciary relationship, the beneficiary of the relationship has the asset, not the holder/manager of the assets.

An example of this situation is an employee pension or health fund, in which assets are held and managed on behalf of the retiree and employee beneficiaries of the trust. The assets are not assets of the employer/sponsor of the fund, nor are they assets of the

trustees if the resources are set up in a legal trust. They are assets of the established trust, but the trust represents the beneficiaries. The benefits of the assets apply exclusively to the beneficiaries of the trust. Within limits, they can specify when and how much of the assets to withdraw and can also confer rights on others, such as dependents and survivors.

Control and Heritage Assets and Infrastructure

An additional question concerning control relates to heritage assets, public infrastructure, parks and other community assets, and other assets that some have referred to collectively as “assets in the public domain.” If control is held to mean the reporting entity’s ability to access for itself the benefits embodied in an asset, and its ability to deny or regulate other entities’ access to those benefits, does that mean that public domain assets do not qualify as assets of a governmental entity when the public at large has access?

Again, the answer appears to be “no.” Arguably, these assets exist to help meet the entity’s mission and goals, and the benefits embodied within them apply to the reporting entity as well as the entity’s constituents through their use in the entity’s programs.

This issue has been discussed more extensively in the Australian and New Zealand frameworks than in the FASB’s. With reference to the position of the AARF and ASB in Australia’s SAC 4, an article by the AARF’s executive director notes as follows:⁷

There was, and in some quarters still is, a view that certain types of public-sector “assets” warrant a different accounting treatment from conventional long-lived assets. The assets in question are variously described as infrastructure assets (eg, transport systems), heritage assets (eg, monuments, libraries and works of art) and community assets (eg, parks and recreational reserves).

The board took the view that these items possess the essential characteristics of assets. Accordingly, where they meet the SAC 4 asset-recognition criteria they should be recognized in the statement of financial position and depreciated over their useful lives. Consistent with the SAC 4 definition of assets, they did not accept the view that these items are not assets if they do not generate future net cash inflows. This argument was presented by a number of commentators, particularly in respect of community and heritage assets. The board held that the items possess service potential (scarce capacity) and are used by the entities that control them to provide goods and services to beneficiaries in accordance with their operating objectives. This is not to say that the board did not acknowledge the potential difficulties in ascribing a value to these assets for financial reporting purposes. However, they drew a distinction between asset existence and asset measurement and observed that difficulties with the latter do not preclude the former.

⁷ Warren McGregor, “The Pivotal Role of Accounting Concepts in the Development of Public Sector Accounting Standards,” *Australian Accounting Review*, Vol. 9, No. 1, 1999, pages 5–6.

Control and the Federal Government's Ability to Control Any Resource

A final issue with respect to the concept of control as an essential characteristic of assets is whether that concept effectively means that everything is an asset of the federal government, given the federal government's ability to assume control of any resource. This issue was raised during the December FASAB meeting.

I believe the answer is "no," because none of the essential characteristics should apply in isolation of the others. That is, all three characteristics have to exist in order for an item to meet the definition of an asset. The third essential characteristic is "The transaction or other event giving rise to the entity's right to or control of the benefit has already occurred." Thus, the ability to assume control would seem to be insufficient; there would need to be an action or other event that would indicate that the entity has assumed control, whether or not the entity actively exercises control at a particular point in time. This view also explains why what appears to be a government's primary asset—the power to tax—does not, in fact, meet the definition of an asset for financial reporting purposes unless and until an action is taken to exercise that power.

Summary and Alternatives

As illustrated by the excerpts presented in this paper, the FASB and several other standard-setting bodies have concluded that legal ownership is not an essential characteristic of an asset. The only authority that I am aware of that has included a concept of ownership in its definition of an asset is the General Accounting Office (GAO):⁸

An asset is any item of economic value owned by a governmental unit. The item may be physical in nature (tangible) or a right to ownership (intangible) that is expressed in terms of cost or some other value. . . (Page 4)

The GAO's definition is followed by identification of three essential characteristics of an asset. These characteristics are essentially the same as those identified by the FASB. The second characteristic is: "The entity can obtain the benefit from it and control access to it." Note that no specific reference is made to ownership in this characteristic (or in the other two), even though ownership is specified in the definition itself.⁹

All the authorities cited in this paper (including the GAO) consider control by the entity to be an essential characteristic of an entity's assets. Many also acknowledge that ownership is a common characteristic of assets. However, using leases as an example, several of them indicate that they do not view the "asset" as the item of property itself, but rather as either the economic benefits embodied in the item of property or the reporting entity's right of access to those benefits. As such, the concern with including

⁸ U.S. General Accounting Office, Policy (Title 2, 1984), Appendix 1.

⁹ I was unable to investigate the point, but it seems likely that the definition of asset and the listing of essential characteristics were prepared at different times, with the latter being based on FASB Concepts Statement 6 and the former based, perhaps, on an earlier document of the GAO.

the term “owned” or “ownership” in the characteristics appears to be that a strict construction of ownership as a legally enforceable property right would exclude certain rights, such as leases. The authorities believe capital leases provide economic benefits to (and confer obligations on) a lessee and, therefore, should be considered assets (and liabilities) of the lessee, notwithstanding that the lessor owns the item of property.

These arguments also would seem to be appropriate considerations for defining federal government assets and their essential characteristics. That is, the notion of an asset as a “bundle of benefits,” rather than as a single item of property or claim, would seem useful in the federal environment, where, just as in the private sector, different entities may have different rights in the same item of property (ownership of a building, for example, versus lessee rights).

Alternative 1:

From that perspective, it seems appropriate to conclude that legal enforceability of ownership is *not* an essential characteristic of an asset and, therefore, a reference to ownership should *not* be included in the definition of an asset.

If the FASAB adopts that view, I believe it would be important to explain very clearly *why* ownership is not an essential characteristic, what is meant by a “bundle of benefits” (or a term with equivalent meaning), what is meant by “control,” especially in the absence of legal enforceability, and so forth. It would be useful also to provide some examples appropriate to the federal environment, to further clarify the discussion.

Alternative 2:

An alternative view is that, because most assets *are* owned by the reporting entity, it is inappropriate and potentially confusing to omit a reference to ownership in deference to the less likely situation, thereby ignoring the more likely situation. In addition, the notion of control of access—almost unanimously emphasized by the standard-setting bodies cited in this paper—becomes more difficult to understand when ownership is *not* held to be an essential characteristic. Though control without legally enforceable ownership is explainable through the notion of “bundle of benefits,” that notion also is a difficult one to explain, especially to those who intuitively (or from their introductory accounting courses) believe that assets are “things of value owned by an enterprise,” as stated in many texts.

If the FASAB prefers Alternative 2, then I believe that a concept of ownership *could* be expressly included in both the definition of a federal government asset and in the identification of essential characteristics, provided that what is meant by “ownership” is carefully explained in the concepts statement. That is, the reasoning would be essentially the same as under Alternative 1; only the wording of the definition and essential characteristics and, therefore, the accompanying explanations, would be different. For example, the text would explain that the term “ownership” does not apply exclusively to having legally enforceable title to, say, a building, but rather to having any right or claim

to the benefits embodied in the building, and different entities may hold rights or claims to different benefits embodied in the same building and be able to control access to those benefits, with or without legal enforceability. Again, some examples specific to the federal government would aid understanding.

Staff Recommendations

1. I believe that either Alternative 1 or Alternative 2 would work, with appropriate explanations and examples. Personally, I prefer Alternative 1—omission of a reference to ownership (except for a discussion of its non-essential role in identifying an asset), because I believe it is a conceptually purer view of the nature of an asset. Under Alternative 1, the second essential characteristic of an asset would refer to control, but not to ownership.
2. I am doubtful whether the FASB's notion of an entity's "obtaining" economic benefits (see asset definition, page 2) is necessary and it is confusing. For example, the definition refers to "benefits obtained *or* controlled by a particular entity," whereas the FASB's characteristic b) refers to "obtain . . . *and* . . . control" (*emphasis added*). If the FASAB adopts the notion of obtaining benefits as well as controlling them, then I believe the terminology should be conformed in the two places where the terms are used: either "obtain *and* control" or "obtain *or* control." I believe the former is what the FASB intended. However, I believe it would be less confusing to specify only control and explain that control presumes that the benefits are obtained by the reporting entity, and I recommend that approach.
3. My recommendation, therefore, is that the definition of federal government assets be based on the following three essential characteristics. (The wording below is not intended to be precise and is not part of this recommendation, which addresses only the concepts involved.)
 - a) There exists a (probable) future benefit (or service potential) to the reporting entity.
 - b) The reporting entity controls others' access to the benefit
 - c) The transaction or other event giving rise to the reporting entity's control of the benefit has occurred by the balance sheet date.

Does the Board agree with these recommendations?

Suggestions for the Next Meeting

Precise language is, of course, very important and the Board will wish to discuss the wording of each characteristic at the next meeting(s). However, it is hoped that

agreement can be reached at this meeting on the concepts underlying each characteristic. This will enable the staff to proceed to offer suggestions for language at the next meeting, with discussion of the pros and cons of alternatives.

The following are some of the language issues that have been raised at previous meetings and merit further consideration. (They also contain some conceptual issues; however, I believe those can be addressed at the same time as developing language alternatives.)

- a. Should essential characteristic a) refer to resources, economic benefits, or service potential? Should a reference be made to future cash flows? Should a reference be made to supporting the government's mission, goals, or programs?
- b. Is it the economic benefit or service potential that is the asset, or is it the government's right to or claim to that economic benefit or service potential?
- c. Should a concept of probability be included in the definition of an asset (and in the supporting essential characteristics) or is probability purely a measurement and recognition concept?